

CAPITAL GAINS RESERVE

A person who sells a piece of capital property may find it advantageous to receive the sales proceeds over a number of years. The seller benefits from such a strategy because he or she is able to dispose of the entire property, while the extended payment stream eases the cash flow pressure on the buyer. The seller can use this tactic to entice a buyer by providing financing arrangements that may be more attractive than might otherwise be available through traditional bank financing.

In these situations, the Income Tax Act provides a special form of relief known as the capital gains reserve. This reserve allows the seller to bring the gain into income over a maximum five-year period. Without the capital gains reserve mechanism, the seller would be liable for tax on the capital gain triggered by the disposition in the year of sale, even though he or she would not yet have received the entire sale proceeds. The problem could be further exacerbated if the income tax liability were greater than the portion of the sale proceeds received in the year of sale.

In order to claim the reserve for a year, a portion of the sale proceeds must be payable after the end of the taxation year. It should be noted that sale proceeds payable under a demand promissory note are not necessarily due after the end of the current taxation year. The reserve is only available where the seller is a Canadian resident at the end of the year and throughout the following year.

In the year of sale, the capital gains reserve is a deduction from capital gains otherwise calculated on Schedule 3 of the return. In subsequent years, the reserve from the prior year is added into income and a new reserve is calculated and deducted from income. (This mechanism is set out on CRA Form T2017.) In this fashion, the entire capital gain from the sale is eventually brought into income.

The capital gains reserve is the least of the following amounts:

1. eighty per cent of the original gain in the year of the sale, 60 per cent in the first year after the sale, 40 per cent in the second year after, 20 per cent in the third year after and nil in the fourth year after the sale
2. a reasonable amount taking into account the amount of sales proceeds deferred to a future taxation year. Generally, a reasonable amount has been taken to mean:

$$\frac{\text{the capital gain} \times \text{amount due after the end of the taxation year}}{\text{total proceeds of disposition}}$$
3. any amount smaller than the above, at the discretion of the taxpayer. Note, however, that the reserve claimed in any particular year cannot exceed the amount claimed for the previous year for that property (i.e., the reserve mechanism cannot be used to create a capital loss in a year). As a result, if the seller claims a smaller reserve for a year under this option, that choice could limit the reserves that would be allowed in subsequent years.

This formula is structured to ensure that the gain is brought into income within five years at most. Assume, for example, that an individual sells a property for proceeds of \$250,000 and realizes a capital gain equal to \$100,000. He receives \$50,000 at the time of the sale and \$50,000 in each of the following four years.

In the year of the sale, he reports a capital gain of \$100,000, but is allowed to claim a reserve of \$80,000. In the first year after the sale, he must include the prior year reserve of \$80,000, but is allowed to claim a reserve for \$60,000 (for a net \$20,000 capital gain). This pattern continues. Under the capital gains reserve mechanism, then, in the year of sale and each of the following four years, he will report a net capital gain of \$20,000.

Special rules lower the 20 per cent factor to 10 per cent in the case of a disposition of a small business corporation or family farm property to the taxpayer's child. This provides for taxation over a maximum 10-year period, instead of the normal five years.

From a planning point of view, the capital gains reserve helps taxpayers by providing the opportunity to more closely match the cash flow for the income tax liability to the cash flow from the proceeds of disposition. However, it is important to remember that a reserve cannot be claimed in the year of death. This means that any remaining deferred income and the related tax liability must be fully recognized in the year of death. Planning should ensure that the associated cash flow is properly reflected in the taxpayer's capital needs analysis.

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STATISTICALLY SPEAKING

Recognition of inflation is integral in most financial planning. Statistics Canada recently summarized the findings of a study in which the consumer price index (CPI) tracked the rate of inflation experienced exclusively by seniors, aged 65 and over, as a group during the period 1992 to 2004. These results were compared with the rate of inflation experienced by *all other households* and *all households combined*, over the same 12-year span.

Overall, seniors-only households experienced an average annual rate of inflation of 1.95 per cent, which was marginally higher than the 1.84 per cent rate for all other households and 1.86 per cent for all households combined. While the results were not astonishingly different in overall numbers, there were a few variances worthy of comment.

The study examined inflation differences that arose due to differences in spending patterns between the seniors-only group and all other households. A 2001 Statistics Canada

Survey of Household Spending reported that seniors tend to spend proportionally more of their income on travel, reading materials, utilities and cable television subscriptions. Alternatively, this same group tends to spend a smaller proportion of their income on alcohol and tobacco products, most types of entertainment and clothing.

The inflation study found that seniors who were homeowners experienced a much greater rate of inflation than renters within this same group. For the 12-year period under consideration, the national rate of inflation was 28.1 per cent for seniors who owned their home compared with only 22.7 per cent for seniors who were renters.

This study is an excellent reminder that assumptions should be carefully chosen to reflect the individual's actual circumstances when planning for inflation.

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DISABLED CHILD

For many parents, the fulfilment derived from caring for a disabled child is an integral part of their daily life. The costs associated with many special needs and with long-term care can be significant, however. Fortunately, there are a number of opportunities for tax planning that should not go ignored.

The following points discuss some tax credits that may be available to families with disabled children or other family members. Please note this is not a complete list and does not cover deductions (e.g., attendant care expenses, child care expenses, the disability supports deduction introduced in the 2004 federal budget) or other benefits such as the

Child Disability Benefit, that might be available.

This area tends to be complex given the number of different deductions, credits and benefits and possible interactions between them, so it is advisable to pay particular attention to the details and to seek professional advice. While the credits noted below are in respect of 2005 federal income taxes, provincial income taxes will typically reflect similar types of tax credits.

Medical Expense Tax Credit: Family medical expenses paid by the taxpayer could create a tax credit to the extent the medical expenses exceed the lesser of \$1,844 and three per cent of the taxpayer's net income. The \$1,844 figure is, like most personal tax credits, adjusted annually for inflation. Family medical expenses include those expenses paid on behalf of the taxpayer, his or her spouse or common-law partner and children less than age 18.

In addition, the medical expense tax credit has been expanded to include medical expenses paid by the taxpayer on behalf of a dependent relative. The taxpayer can claim medical expense in excess of the lesser of \$1,844 and three per cent of the dependant's net income to a maximum of \$10,000 (this maximum was recently doubled under the 2005 federal budget).

Note that in addition to the more common types of medical expenses, eligible expenses also include tuition paid for specialized care at a school and for caregiver training. Check carefully to confirm that a specific expense qualifies since medical expenses are often very specifically defined.

Caregiver Tax Credit: A taxpayer can claim \$3,848 as a tax credit amount for an adult family member who lives with and is dependent on the taxpayer. Eligible dependants include parents or grandparents over the age of 65 and other family members who are over age 18 and are dependent because of physical or mental disability. Such dependants could include adult children, brothers, sisters, aunts, uncles, nephews or nieces of the taxpayer or the taxpayer's spouse or common-law partner.

The caregiver tax credit claim is reduced by \$1 for every \$1 of the dependant's net income in excess of \$13,141 (indexed).

Infirm Dependant Tax Credit: A taxpayer can claim \$3,848 as a tax credit amount for each related individual who is 18 or over and is dependent on the taxpayer because of a physical or mental infirmity. The claim is reduced by \$1 for every \$1 of the dependant's net income in excess of \$5,460.

Note that the criteria for the infirm dependent credit are very similar to that for the caregiver credit, but the dependant's income threshold is much lower. Thus, the infirm dependant tax credit will generally only be claimed where the dependant does not live with the taxpayer and so is not eligible for the caregiver tax credit. (Note that the infirm dependant credit cannot be claimed where the caregiver credit has been claimed for the same person.)

“Equivalent to Spouse” Tax Credit: Briefly, it should be noted that a taxpayer may claim the eligible dependant tax credit (also called the “equivalent to spouse” credit) for a disabled family member who lives with them where the taxpayer does not have a spouse or common-law partner. This credit amount is \$6,919 and is reduced where the dependant's net income exceeds \$692. Note, however, that restrictions will be imposed on claiming the caregiver tax credit or the infirm dependant tax credit where the eligible dependant tax credit has been claimed.

Disability Tax Credit: To the extent that an individual with a disability qualifies to claim the disability tax credit but does not require this credit to reduce his or her tax liability to zero, the excess can be transferred to the supporting taxpayer. A “supporting person” is specifically defined for this purpose.

Tax Credit for Tuition Fees and Education Amount: Similar to the disability tax credit, the disabled individual can transfer tuition and education tax credits to a supporting person. The amount that can be transferred is the lesser of \$5,000 and the amount not needed by the disabled individual to reduce his or her tax liability to zero.

Note that a disabled individual is entitled to \$400 per month as an education amount irrespective of whether he or she is a full-time or part-time student.

CASH TRANSACTIONS

Cash transactions do not make a business illegal as long as the owner reports the related revenue and pays the appropriate taxes. In reality, there are countless legitimate Canadian businesses that sell products or services for cash. However, when a business owner does not declare the revenue as a means to reduce income and taxes, this behaviour translates into the “underground economy.”

Individuals who operate in the underground economy may seemingly become quite prosperous. Of course, by not reporting or underreporting income, these individuals expose themselves to significant risk. The Canada Revenue Agency (CRA) could discover such operations based on an audit of the individual or other associated persons. Such audits are often based on tracking specific sales revenue and/or assessing personal expenditures or a change in the individual's net worth.

Failure to file a tax return or to report income can have significant financial implications. The Income Tax Act provides a penalty for the failure to file a tax return. The penalty is equal to five per cent of the tax owing plus one per cent per month that the tax owing remains outstanding (to a maximum of 12 months). To the extent the taxpayer filed a tax return but underreported the amount of income, the Income Tax Act imposes a penalty equal to the greater of \$100 and 50 per cent of the difference in tax liabilities. These penalties increase substantially for repeat offenders.

In addition to the above penalties, the taxpayer is also liable for interest charges from the original date that the taxes should have been paid. The rate of interest is adjusted quarterly and is equal to the prescribed rate plus four per cent. Furthermore, any interest expense in respect of unpaid taxes is not tax deductible.

Depending on how long the income taxes have been outstanding, it is quite possible that the individual could end up paying almost as much in taxes, interest and penalties as the unreported income. In some cases, individuals may face criminal proceedings related to their outstanding tax balances. If convicted, they may face stiff fines and even jail time.

Voluntary disclosure may lessen the impact of potential late-filing penalties. Whether because of a guilty conscience or fear of being caught, many taxpayers decide to admit to their outstanding income tax liabilities. The CRA has a process for voluntary disclosure whereby it is possible to avoid or lower penalties and criminal prosecution, provided the taxpayer makes a *valid* disclosure and is not already under investigation at that time.

Finally, in the process of administering an estate, the CRA may become aware that the deceased has not filed an income tax return or appears to be wealthier than what the recent tax returns could justify. In either case, the CRA has prior claim on all of the assets of the estate, assets recently transferred plus assets purchased from the unreported profit. The existence of such a contingent liability may interfere with the administration of the estate.

While an individual may downplay the chance of getting caught underreporting income, is this a risk he or she wants to take? The CRA has published statistics with respect to their audit numbers, which reveal almost 25,000 audits over the last two years resulting in \$144 million of additional income tax plus interest and penalties of \$44 million.

Note that this article only addresses the issue in respect of income taxes. Similar rules apply to other taxes such as goods and services tax (“GST”) and provincial sales tax.

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